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September 16, 2005

## **AGENDA ITEM 6**

### **TO: MEMBERS OF THE FINANCE COMMITTEE**

- I. SUBJECT:** Extension of Independent Real Estate Auditor Contract
- II. PROGRAM:** Audit Services
- III. RECOMMENDATION:** Finance Committee approval and recommendation to the Board of Administration of a one year contract extension of the independent real estate auditor contract, from May 2006 to April 2007.  
  
Finance Committee approval of the concept for preparing a Request For Proposal for a Spring Fed Pool of qualified audit firms for real estate compliance audits.
- IV. ANALYSIS:**

The independent real estate auditor contract, previously approved by the CalPERS Board, to perform compliance audits of real estate investment advisors and partners expires April 30, 2006, unless extended. The existing contract authorizes two separate one year extensions, beyond the five year contract term. The Office of Audit Services anticipates extending the existing contract for the first one year period from May 1, 2006 through April 31, 2007 to continue the existing audit process, and to provide the time necessary to conduct a request for proposal intended to replace the existing contract with a spring fed pool of qualified audit firms from which specialized firms will be selected to perform compliance audits as they are considered necessary.

### **BACKGROUND**

Since its inception in 1992, the real estate audit program has sought to provide the Board of Administration and the Investment Office with an independent third-party evaluation of real estate general partners', advisors', and property managers' compliance with their contractual obligations to provide real estate investment and management services.

The Board approved a request for proposal (RFP) in October 2000, and selected, in February 2001, Conrad and Associates as its Real Estate Compliance Auditor. Audits of individual investments in the real estate portfolio during the first three years of the contract occurred every five to six years. Since the original contract authorization, real estate portfolios have grown significantly in both size and complexity. In particular, the number of real estate partners increased to 40 so the number of auditable entities has correspondingly increased and the dollar value increased to over \$21 billion (gross amount).

Consistent with the Board of Administration's policy of having an independent third-party evaluation of investor activity and at the request of the Investment Office, the frequency of real estate compliance audits has been increased to a bi-annual rate over the final twenty-two months of the original contract. As of March 31, 2005, CalPERS' Real Estate Unit contracted with advisors and partners for ten core, and thirty non-core investments. Under the bi-annual compliance audit cycle, as many as five core and fifteen non-core investments are selected for review each year.

The current bi-annual cycle represents a three fold increase in the number of audits that were completed each year under the original contract. To fund the increased frequency of ongoing audits, the original contract was amended in June 2004, by \$549,300. The increased rate of audits has provided investment staff with more timely information necessary for investor oversight and intercession on issues or problems identified by the audits. The increase in real estate compliance audit frequency has improved CalPERS' ability to exercise its fiduciary responsibility to members, as it relates to administration of the real estate investment portfolio.

This extension will allow the continuance of real estate audits on a bi-annual cycle and provide the time necessary to develop a new request for proposal (RFP). The RFP will be issued to create a pool of approved audit firms from which individual firms may be selected to perform individual compliance reviews. The spring fed pool of qualified firms will provide a variety of auditors with various qualifications from which to select for audits matching specific audit firm qualifications the type of investment under review from the complex mixture of real estate investments.

**V. STRATEGIC PLAN:**

This agenda item addresses the Board's fiduciary oversight responsibility of the real estate investment portfolio consistent with the California Constitution.

Additionally, this agenda item relates to Business Objective 10, To achieve long-term performance returns, of Strategic Goal 3, to design, develop, and administer benefit programs and business processes that are innovative, effective, efficient, and valued by our members, employers, and stakeholders.

**VI. RESULTS/COSTS:**

Approval of an extension of the existing contract with Conrad and Associates, from May 1, 2001 through April 30, 2006, to perform independent audits of Real Estate Investments will provide the Board of Administration and the Investment Office with timely assurance that the real estate general partners, advisors and managers are meeting their contractual real estate investment and management obligations.

The original contract included an annual increase in the audit fee budget of 10% per contract fiscal year, May 1 to April 30, to reflect the anticipated increase in the size of the real estate portfolio at the time that the RFP was written in 2000. The other assumptions were that the total number of real estate partners would remain limited in accordance with the plan adopted by the Board in the mid-1990's, and that the audit cycle would be 5 or 6 years. The total amount of the original contract was \$1,831,000. Subsequently, the real estate portfolio grew faster than anticipated, the number of real estate business partners increased to 40, and the Real Estate Unit requested that the audit cycle be reduced to two (2) years. In order to accommodate these business needs, the contract was increased by \$549,300 (30%) in June of 2004, and the total contract amount became \$2,380,300. In order to keep pace with the accelerating business needs, we are requesting that this contract be extended by one year for a total of \$618,878, which is a 26% increase in the amended contract. This contract extension will allow for development and issuance of a new Request for Proposal using the spring fed pool concept level while continuing audits on an approximate bi-annual cycle. The spring fed pool concept will introduce more efficiency and cost savings into the audit process. The proposed total amount of the contract, including this proposed amendment, is \$2,999,178.

The following table illustrates the annual fee schedule for the proposed life of the Boards' Independent Real Estate Auditor contract.

Fiscal Year (FY)	Original Contractor Fee Amount	Amended Fee, June 2004, for F/Y 2004/05 & 2005/06	Proposed Amendment for F/Y 2006/06 & 2006/07
FY 2000-01, May - June	\$30,000		
FY 2001-02	\$325,000		
FY 2002-03	\$335,000		
FY 2003-04	\$369,500		
FY 2004-05	\$405,667	\$294,833	
FY 2005-06, July - April	\$365,833	\$254,467	
FY 2005-06, May - June	TBD Extension	TBD Extension	\$80,200
F/Y 2006-07, July - April	TBD Extension	TBD Extension	\$538,678
Amendment Amount	NA	\$549,300	\$618,878
<b>TOTAL CONTRACT</b>	<b>\$1,831,000</b>	<b>\$2,380,300</b>	<b>\$2,999,178</b>

As shown in the table above, a \$618,878 extension to the amended Conrad and Associates contract represents a 26% increase of the amended contract.

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Office of Audit Services

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